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## WILL HIGH PRICES CONTINUE?<sup>1</sup>

BY IRVING FISHER

At the present time there is a marked halt in production. Industry is slowing down. Unemployment of labor increases. Some industrial concerns are failing to earn profits, and others are suffering the dissipation of their accrued profits, because, even by shutting their plants down, they can not save certain of their expenses or any of their fixed charges. The Government's revenues, dependent as they are upon the national income, may fall short at the very time we need them most. In brief, we are threatened with a widespread business depression and from peculiar causes, for the unsound conditions usually preceding a widespread business depression are absent.

The main reason why business is not going ahead better is that most people expect prices to drop. The merchant is selling, but not buying. The manufacturer holds up the purchase of his raw materials. People quote the disparity between present prices and those prevailing "before the war," and decide they will not buy much until present prices get down to "normal." This general conviction that prices are sure to drop is putting a brake upon the entire machinery of production and distribution. Readjustment waits because we keep on waiting for it. We have waited in vain for over three months. It is interesting to observe that

<sup>1</sup>During March and April many conferences of men prominent in commercial and industrial circles were held with heads of various departments in Washington, for the purpose of accelerating the resumption of peace-time activities. The chief cause of delay in starting construction work on a large scale had previously been ascribed to high prices for materials and labor. Irving Fisher, professor of political economy at Yale University, who had been advising the Treasury Department on monetary matters during the war, was accordingly invited to prepare for the use of these conferences, an explanation of the reasons given by economists for resuming construction now, without waiting for a fall in prices. His discussion is printed here by the Publication Committee, in accordance with the desire of the federal departments concerned in commercial and industrial affairs, to bring the subject to the attention of all public officials in charge of construction of any kind.

many manufacturers think that prices must come down, including the price of labor; but they are ready to demonstrate to you that their own prices can not come down, nor can they pay lower wages. Almost everything they buy somehow costs twice as much as before the war, and their labor is twice as dear. They can not pay their labor less if labor is to meet the increased cost of living. Now, as a matter of fact, when we investigate almost any individual one of the so-called high prices for industrial products we are likely to find that individually it is not high; that is, it is not high relatively to the rest. Our quarrel is with the general level of prices.

Variations in the general price level may be compared to the tides of the sea, while individual prices may be compared to waves. Individual prices may vary from this general level of prices for specific reasons peculiar to individual industries, just as the height and depth of waves vary from the general level established by the tide. The causes controlling the general price level are as distinct from those controlling individual prices as the causes controlling the tides are distinct from those controlling individual waves.

All prices have risen, but some have risen more, some less, than the average for particular reasons affecting each industry. In some cases an improved organization of both employers and employees has enabled them to combine against the public and take full advantage of the price advance. The war brought about an abnormal demand for certain products like copper and steel, and they advanced faster than the average. The abnormal demand having disappeared, these prices are being adjusted downward. Wheat is a case where demand increased and at the same time certain of the usual sources of supply—Russia, Australia, and Argentina—disappeared, with a resultant abnormal price increase. The closed sources of supply have opened again and wheat prices in the world market have dropped. In some cases, as in many of the industries making building materials, the war meant a great slackening in demand, an enforced curtailment in use by Government order. In such instances we are likely to see an upward swing in prices as the suppressed demand again makes itself felt. To-day we are witnessing throughout the country such price readjustments, up and down, but the general price level has shown little sign of falling, as is evidenced by price index numbers. It is apparent to every thoughtful observer that some great force has affected all prices, creating a new standard to which they are all conforming.

The fundamental practical question confronting business men is whether the general level of prices is going to fall. In my opinion, it is not going to fall much, if at all. We are on a *permanently* higher price level, and the sooner the business men of the country take this view and adjust themselves to it the sooner will they save themselves and the nation from the misfortune which will come if we persist in our present false hope.

The general level of prices is dependent upon the volume and rapidity of turnover of the circulating medium in relation to the business to be transacted thereby. If the number of dollars circulated by cash and by check doubles while the number of goods and services exchanged thereby remains constant, prices will about double.

The great price changes in history have come about in just this manner. The "price revolution" of the sixteenth century came upon Europe as a result of the great influx of gold and silver from the mines of the New World. Europe was flooded with new money. More counters were used than before in effecting exchanges and prices became "high." People talked then of *temporary* "inflation," just as they talk of it now. But it was not temporary; it was a new price level.

A similar increase in prices all over the world occurred between 1896 and 1914, following the discovery of the rich gold fields of South Africa, Cripple Creek, and Alaska, the invention of the cyanide process in mining, and the vast extension of the use of bank credit.

Circulating credit—that is, bank deposits subject to check and bank notes—is a multiple of the banking reserve behind these deposits and notes; and the essence of this reserve is gold. Our present monetary system is an inverted pyramid, gold being the small base and bank notes and deposits being the large superstructure. The superstructure grows even faster than the base. The deposits are the important elements. They are transferred by check from one individual to another; that is, the circulation of checks is really the circulation of deposits.

Thus any increase in the country's gold supply has a multiplied effect. The possible extent of that effect is dependent upon (1) the amount of gold available, and (2) the gold reserve requirements, determining the volume of credit that can be put into circulation based upon the gold. Over a billion dollars in gold has come into

this country from abroad since 1914, and a large amount has disappeared from domestic circulation. The gold from both these sources has found its way into the United States Treasury and into bank reserves. On June 30, 1918, the portion of the *gold* reserve of the Federal reserve banking system which supported national bank deposits and Federal reserve notes was more than three times as large as the gold reserves under the old national banking system on June 30, 1914—\$1,786,000,000, compared to \$592,000,000. During the same period credit instruments (demand deposits and notes) increased about twofold—from \$6,100,000,000 to \$11,700,000,000. This increase of credit instruments is typical of the banking situation for the country as a whole and largely explains the present high level of prices. The increase of gold has been so great, however, that the base has grown faster than the superstructure—which is contrary to the normal tendency. The ratio of gold to credit has risen from 9.6 per cent to 15.3 per cent. The legal reserve requirements of the present system are such that for 1918 there is an excess of gold above these requirements of more than \$700,000,000. The reserve required by law to support the \$11,700,000,000 of credit instruments of 1918 is \$1,070,000,000. The \$700,000,000 of free gold could support an additional superstructure 70 per cent as large as the existing one, which indicates that for the banking of the country as a whole a potential future expansion of 50 per cent is a conservative estimate.

Many people, referring to this inflation in the circulating medium, and assuming that it is temporary, are waiting for this inflation to subside. When we speak of *inflation* we mean more circulating medium than is needed to transact the business of the country on a given price level. But what price level? Some people mean the price level of 1913-14. Our currency is certainly inflated in terms of the prices of that period, just as the currency of 1914 was inflated with respect to the prices of 1896, but our currency is not inflated at the present time relative to the new level of prices in the world which the war has brought. The country's volume of money will have to be judged in terms of this new price level, not in terms of a price level that is past. To speak of the present "inflation" as temporary is to assume the very thing about which we are contending—to assume that the normal prices are those of 1914.

Let us examine the factors upon which any future price movements must depend.

1. *Gold will not return to circulation.* No great effect in the direction of falling prices can be expected from any return of gold and other lawful money into daily circulation. Such a reversion would be contrary to monetary experience everywhere. When people have learned to leave their gold and silver in the banks and use paper money and checks instead they find the additional convenience so great that they will never fully return to the old practice.

2. *No great outflow of gold through international trade.* It should be noted that many of the former reasons for a flow of gold from America abroad have disappeared. We used to owe Europe a huge balance of interest payments upon American securities she held. The situation is reversed to-day. Moreover, Europe must pay us money for the materials we will send her for reconstruction, or at least pay us interest on credit we will extend her. Thus our exports will probably exceed our imports during the reconstruction period. We used to pay ocean freight money to foreign carriers; to-day the American merchant marine will keep in American hands tens of millions of dollars of ocean freight money. The huge volume of American tourist travel abroad, for whose expense we had to settle, has stopped and can not resume for a year at least. For all these reasons the lines are laid for a movement of gold from Europe here rather than a movement of gold from America to Europe.

"Yes, but," people say, "wait until trade is resumed between the United States and Europe, then surely 'low-priced European goods' will flow over here in such enormous volume that they will liquidate all annual obligations to us in goods." Ultimately Europe must pay her obligations to us in goods, but it will take many years. Meanwhile she needs our tools, machinery, and raw materials for immediate reconstruction.

At the present time European goods are not "low priced" (however little the money wages of European labor will buy). Prices in Europe since the war began have risen more than they have in the United States. The price rise has been less the farther from the seat of hostilities. It was least in Australia and New Zealand. It was next least in the United States, Canada, and Japan. Then came neutral Europe; then our present allies; and finally Germany and Russia. Gold tends usually to flow from high-priced countries to low-priced countries, so that until "inflated" European

prices fall gold is not likely to flow thither. Prices are no more likely to fall there than here, and for the same reasons which will be explained below.

3. *Reduction of outstanding credit.* The chief dependence of those who predict lower prices is on a reduction of the superstructure of credit resting upon our gold rather than on any reduction in the volume of this gold itself. They look for a contraction of bank credit, a reduction in the volume of deposits subject to check, which circulate throughout the country.

But the main cause for the present extension of bank credit is the liberty loan, and there is soon to be another. Subscribers for the new loan will not pay for their bonds in full any more than they did in the previous cases but rather less. Many of them will deposit the bonds with the banks as security for loans to be repaid later. The effect on our circulating medium will be the same as if the Government were to impose a levy of \$6,000,000,000 of credits upon the Federal reserve banks, and then order them to apportion these credits out among the banks of the country. This process will certainly lead to an expansion of credits. The former issues of liberty bonds are still carried by the banks to a considerable extent. It may be contended that the bank credit expansion represented by the new victory notes has already occurred in the form of Treasury certificates, which are merely to be funded by the victory notes. The victory note issued thus represents only a shifting of the obligation to pay credits advanced to the Government, a shifting from the shoulders of the banks to the shoulders of the victory note buyers. The volume of outstanding bank credit remains the same. To a certain degree this contention is true. But a portion of the April victory note issue will go to pay future expenditures, not accrued expenditures. Then as soon as the Government needs additional money, it will issue new Treasury certificates, resulting in new extension of bank credit. Moreover, there is little doubt that there will be at least one more Government bond issue during the reconstruction period and this will tend to further increase our present credit structure.

The banks must lend credit and create deposits to meet the expenditures not only of our own Government, but of foreign Governments as well. The same thing results even if these Governments are served directly by private investors here instead of via the United States Treasury. These investors pay for foreign Govern-

ment bonds as they do for our liberty bonds—on the installment plan—paying a small part down and borrowing the rest from the bank. This increased purchasing power will be mostly spent in this country for supplies to be sent abroad for rehabilitation. This continuance of vast loan issues, connected with war and reconstruction throughout the world is a factor which will maintain the high price level temporarily, which means many months.

It is also worth keeping in mind that liberty bonds and other Government securities held here do not wholly cease being a source of credit expansion when the individual subscribers have completed their payments on the bonds and really own them. These new bonds are unrivaled security for further borrowings from banks for commercial purposes, and they will continue to be so until the Government which issues them redeems them.

The availability of the vast issues of war bonds as bases for future credit expansion, coupled with the fact that our banking system has still many unused reefs, sure to be taken out later, when business wishes to spread more sail, is the chief reason why prices will keep up permanently; that is, for many years.

Between the period of temporary and the period of permanent effects, there may be a slight dip in the price level, say a year from now. If so, it is the more incumbent upon business to proceed now; for it can not wait a year.

During the war the flotation of stocks and bonds of commercial concerns has been very greatly diminished. During the period upon which we are now entering the issue of such securities will increase greatly.

Against any considerable reduction in bank credit and hence in the general level of prices, we shall find the whole business community in arms. Falling prices mean hard times for the individual and for the nation and every one resists the tendency. At the end of the Civil War the Treasury started to reduce the quantity of greenbacks. A start had hardly been made, however, before the business depression of 1866 and 1867 caused Congress to forbid by law any further reduction. Should the Federal reserve banks attempt, by raising their discount rate or otherwise, to reduce the volume of bank credit outstanding they will meet with the same sort of opposition. Moreover, the hostile attitude of labor toward the lowering of wages will deter legislators and bankers from any organized policy of contraction.

Looking into the still more remote future, there will be in Europe, particularly on the Continent, a vast increase in deposit banking. The need of the Governments there for funds during war times hastened the introduction of deposit banking. Money went out of circulation into bank vaults, and there became the basis for circulating credits. This means a new habit which will lead to a great currency expansion. Far-away countries, like India and China, are also learning to use deposit banking. It is as if a new source of gold supply had been discovered. What has been discovered is a new way of using the gold supply. The world, during the course of the war, has thus started, or has hastened, an equivalent of the price revolution of the sixteenth century.

Business men should face the facts. To talk reverently of 1913-1914 prices is to speak a dead language to-day. The buyers of the country, since the armistice, have made an unexampled attack upon prices through their waiting attitude, and yet price recessions have been insignificant. The reason is that we are on a new high-priced level, which will be found a stubborn reality. Business men are going to find out that the clever man is not the man who waits, but the one who finds out the new price facts and acts accordingly.